

REVENUE RECOGNITION UPDATE - A RECAP OF WHAT HAPPENED IN 2009

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During 2009 there were some significant developments regarding revenue recognition accounting standards. Those most relevant to high tech companies include:

- **EITF 08-01¹**, *Revenue Arrangements with Multiple Deliverables (supersedes EITF 00-21)*
- **EITF 09-03²**, *Certain Revenue Arrangements that Contain Software Elements*

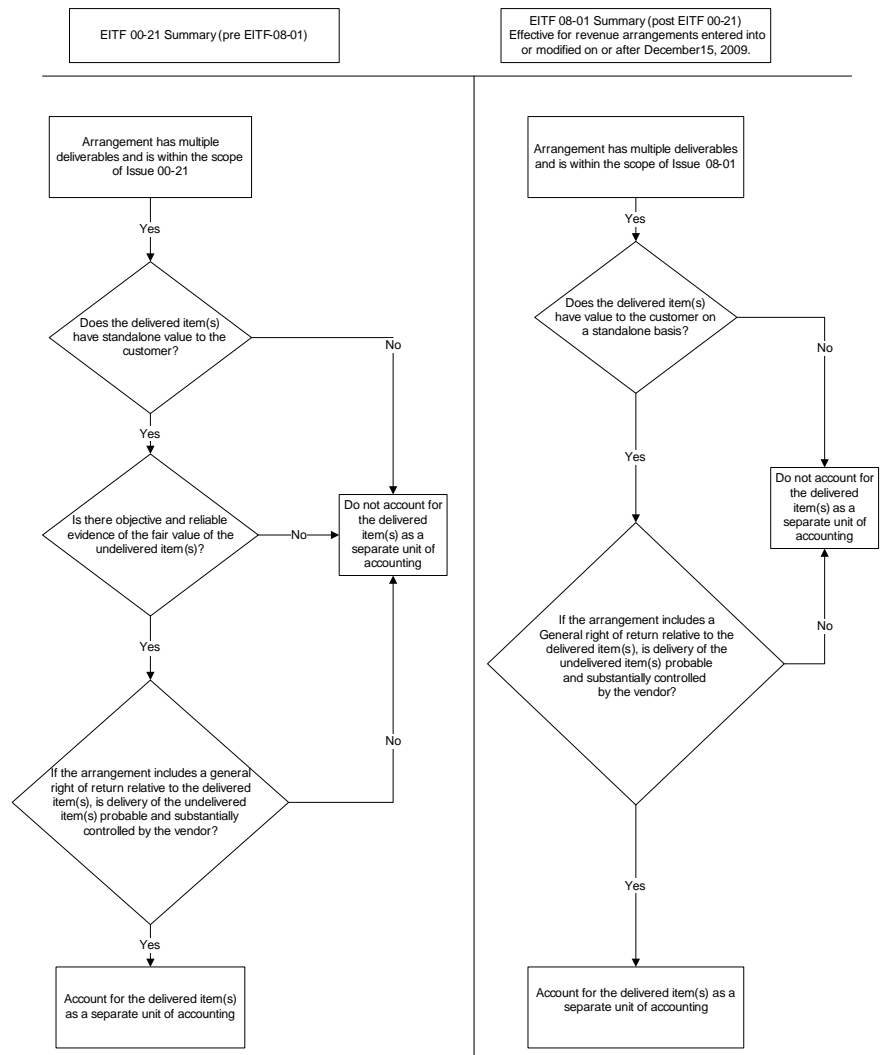
The above standards were both ratified in September 2009 and will have a substantial impact on revenue recognition upon adoption.

EITF 08-01 – Redefining Multiple Elements

EITF 08-01 modifies the guidance on multiple deliverable arrangements previously addressed by EITF 00-21. The most substantial changes relate to the modification of the separation criteria for multiple elements and the elimination of the residual method of recognizing revenue, except as it pertains to software arrangements with multiple deliverables. Exhibit 1 illustrates the differences between EITF 00-21 and EITF 08-01.

Prior to adopting EITF 08-01, if a company was unable to determine the fair value of an undelivered element in an arrangement based on vendor specific objective evidence (VSOE) or objective and reliable third party evidence (TPE), then the deliverables could not be separated for accounting purposes. This often resulted in the deferral of revenue to later periods. Also, if a company could determine the fair value of all the undelivered elements, but was unable to determine the fair value of the elements delivered upfront, a company would only be permitted to recognize revenue upfront based on the residual value (see Scenario B included in Exhibit 3). Thus, resulting in all discounts being applied to the first element delivered in a multiple element arrangement.

Exhibit 1 EITF 00-21 vs. 08-01

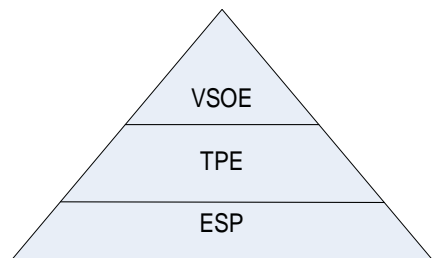


Under EITF 08-01, a company is no longer required to determine if there is objective and reliable evidence of the fair value of undelivered items in order to account for an element separately. Rather, if a company cannot support VSOE of the selling price, or identify TPE, such as a competitor's pricing for a similar product or service, then a company will be permitted to use an estimated selling price (ESP) based on management's judgment. It is important to note that if VSOE or TPE exist, a company may not use ESP.

¹ On July 1, 2009 U.S. GAAP was codified resulting in the elimination of various levels of authoritative literature in to a single standard codification. This article includes references to historical U.S. GAAP with reference to the FASB Accounting Standards Codification (ASC) included in the footnotes, such as Subtopic 605-25 for EITF 08-01

² ASC Subtopic 985-605

Exhibit 2 Hierarchy of Selling Price



EITF 08-01 does not prescribe a method to establish ESP, rather it states that a company’s “best estimate of selling price shall be consistent with the objective of determining VSOE for the unit of accounting; that is, the price at which the vendor would transact if the undelivered element were sold by the vendor on a standalone basis. The vendor shall consider market conditions as well as entity-specific factors when estimating the price.” This leaves management with discretion when determining ESP. Establishing consistent policies and procedures will be essential because when ESP is used as a basis for allocating revenue, management will be required to disclose both qualitative and quantitative information in the footnotes to the financial statements that will enable users of the financial statements to understand the inputs and methodologies used to develop ESP.

The following exhibit illustrates the potential effects of applying the relative selling method versus the other methods commonly utilized under EITF 00-21. Scenario A is the only possible method of allocating revenues after the adoption of EITF 08-01. The three scenarios demonstrate how revenue would be recognized for a company that delivers a monitoring device upfront along with ongoing monitoring services for 2 years with the following assumptions:

Exhibit 3 Allocation of Revenue

Assumptions

	Selling Price of Device	Selling Price of Device
Scenario A	\$500	\$1,000
Scenario B	unknown	\$1,000
Scenario C	\$500	unknown

Actual Contract Price is \$1,250

Scenario A - Application Relative Selling Price Method

The fair value/selling price for both the device and service are known (or can be determined based on ESP under EITF 08-01) and the relative selling price method is utilized.

	Standalone Selling Price	Relative Value	Revenue Allocation
Device	\$500	33%	\$417
Service	\$1,000	67%	\$833
	<u>\$1,500</u>	100%	<u>\$1,250</u>

	Year 1	Year 2	Total
Device	\$417	-	\$417
Service	\$416	\$417	\$833
	<u>\$833</u>	<u>\$417</u>	<u>\$1,250</u>

Scenario B - Application of Residual Method

There is no objective or reliable evidence for the value of the delivered monitoring device, but there is objective and reliable evidence of fair value for the undelivered monitoring services; thus the residual method is applied.

	Year 1	Year 2	Total
Device	\$250	-	\$250
Service	\$500	\$500	\$1,000
	<u>\$750</u>	<u>\$500</u>	<u>\$1,250</u>

Scenario C - Deferral

There is objective and reliable evidence for the value of the delivered monitoring device, but there is no objective and reliable evidence of fair value for the undelivered monitoring services. In this case, you would either recognize the revenue ratably over the service period or at the end of the service period based on the relevant facts and circumstances.

	Year 1	Year 2	Total
Device & Service	\$625	\$625	\$1,250
or			
Device & Service	-	\$1,250	\$1,250

Disclosures Disclosures Disclosures

A vendor should disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance, cancellation, termination, or refund-type provisions.

As mentioned above, a vendor shall also disclose both qualitative and quantitative information on an aggregated basis that enables users of its financial statements to understand the inputs and methodologies used to develop ESP when neither VSOE nor TPE of selling price exists. Information related to individually significant arrangements should be separately disclosed.

A vendor shall separately disclose the amount of its revenue recognized each reporting period under EITF 00-21 and EITF 08-1 until the amount of revenue reported under EITF 00-21 is no longer material to the entity. A vendor shall also separately disclose the amount of deferred revenue as of the end of the period which is recognized in accordance with EITF 00-21 and EITF 08-1.

Effective Date and Transition

EITF 08-01 may be adopted prospectively or retrospectively in certain circumstances. If prospective adoption is elected, the guidance will be effective for arrangements entered into or modified in fiscal years beginning on or after June 15, 2010. A company may elect to adopt the standard early on a prospective basis, but must apply the guidance as of the beginning of its fiscal year.

If a company chooses to adopt EITF 08-01 retrospectively, they will be subject to the guidance in Statement of Financial Accounting Standard No. 154³, *Accounting Changes and Error Corrections*, which in some circumstances may be onerous and impractical. In most cases, companies electing retrospective adoption will be required to restate each year of financial statements presented to reflect the financial results as if EITF 08-01 had been adopted, and include disclosures regarding the changes from previously reported amounts.

EITF 09-03, When is software considered software?

Previously, any product that included software which was essential to functionality was required to apply the guidance of SOP 97-2⁴, *Software Revenue Recognition*, including the requirement to use VSOE in order to separate deliverables in a multiple element arrangement. With advancing technologies and the use of software in various products, such as smart phones and networking equipment, it was determined that the scope of SOP 97-2 was having unintended consequences and the EITF decided to reconsider the interpretive guidance previously provided in EITF 03-05, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*.

As a result of EITF 09-03, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of SOP 97-2.

In assessing whether or not a tangible product contains software that works together with the non-software components of the tangible product to deliver the essential functionality of a product the standard setters noted the following factors should be considered:

1. If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exist that software elements are essential to the functionality of the tangible product.
2. A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, they will be considered the same product for the purpose of evaluating the above factor.
3. A vendor may sell software on a standalone basis. The vendor also may sell a tangible product including that same software. The separate sale of the software does not lead to the presumption that the software is not essential to the functionality of the tangible product.
4. Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.
5. The nonsoftware elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

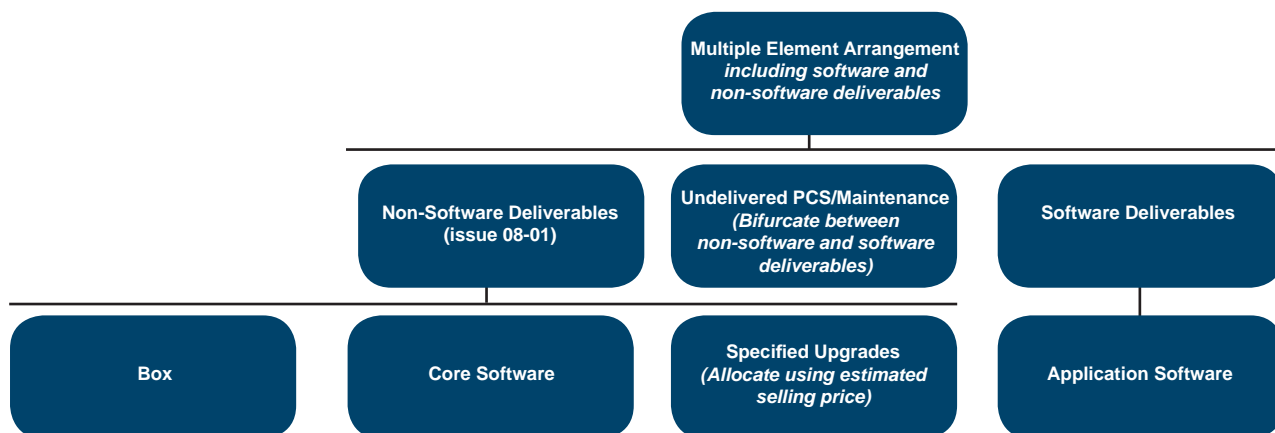
³ ASC Topic 250

⁴ ASC Topic 985-605

Potential Complications

To illustrate the previously noted concepts, consider the sale of a computer that includes an operating system and a computer aided design application (CAD). Since a computer is almost always sold with an operating system, there is a rebuttable presumption that the operating system software is essential to the functionality of the computer, and therefore, these elements would fall outside the scope of SOP 97-2. As for the CAD application, since this application does not contribute to the computer's essential functionality this element of the revenue arrangement would be subjected to SOP 97-2. As a result of EITF 09-03, in this circumstance a company would need to first separate the nonsoftware and software elements in the arrangement based on EITF 08-01, then apply the relevant accounting guidance to the nonsoftware deliverables and SOP 97-2 to the software deliverables (see the below exhibit). Prior to EITF 09-03 the operating system would have been a software deliverable and SOP 97-2 would have applied to the whole arrangement. Now in certain circumstances a company may be required to go through additional procedures in order to properly bifurcate their software and non-software deliverables.

Exhibit 4 Application of EITF 09-03



Disclosures and Effective Date

The disclosures requirements, transition options, and effective date of EITF 09-03 are similar to EITF 08-01.

More Significant Changes to Come

In December 2008, the Financial Accounting Standard Board (FASB) and International Accounting Standards Board (IASB) issued a joint discussion paper expressing their preliminary views on converging revenue recognition standards. The Boards solicited comment letters through June 19, 2009, and are expected to release an exposure draft of a comprehensive revenue recognition standard in 2010 with possible issuance of a new standard by 2011; although an effective date would be much later. The discussion paper noted the flaws with U.S. GAAP, in that U.S. GAAP is extremely complicated due to numerous standards that often define earnings processes inconsistently. The discussion paper also noted that International Financial Reporting Standards (IFRS) lack sufficient guidance as it pertains to revenue recognition, and even the guidance that exists has inconsistencies. The discussion paper focused on a "contract-based revenue recognition principal" in which revenue would be recognized on the basis of increases in a company's net position in a contract with a customer. In other words, revenues would be recognized when a contract asset increases or a contract liability decreases (or some combination of the two). The concepts included in the discussion paper would result in substantial changes to current U.S. GAAP and could be onerous for certain industries to apply, such as the telecommunication and construction industries. The Boards also acknowledged that there were several other topics yet to be addressed as part of the overall project to create a single revenue recognition standard and that further deliberations will continue.

If you have questions regarding the issues discussed in this document, feel free to contact Michael Warren at 404.253.7458 or michael.warren@frazierdeeter.com.

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